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No. 10236

In the United States Circuit Court of Appeals

For the Ninth Circuit

SAM KLEINMAN,

Appellant,

vs.

PAUL W. SAMPSELL, Trustee in Bankruptcy of the Estate of Abraham Zemansky, David Zemansky and Sol Zemansky, doing business under the fictitious names and styles of Provident Loan Association and State Loan Office, Bankrupts,

Appellee.

Opening Brief of Appellant

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OPENING BRIEF OF APPELLANT

INTRODUCTION

This is an appeal from that portion of the order of the Honorable Harry A. Hollzer, United States District Judge, dated June 8, 1942* (Tr. 81, 82), which in substance and effect adopts the Findings of Fact,

*(The abbreviation Tr. will be used herein to refer to the Transcript of Record.)

Conclusions of Law and Order of the Referee in Bankruptcy, Honorable Benno M. Brink, in the above entitled matter adjudging the claim of the Appellant to be an unsecured claim. (Tr. 25 to 37.)

Attention is directed to the fact that the Referee allowed offsets for usury in favor of the Trustee. Upon Petition for Review of the Referee's Order, the District Court disallowed the offsets and allowed the Appellant's claim as a general unsecured claim in the sum of $109,545.73. From this Order, reversing the Referee's Order with respect to claimed offset for usury, no appeal has been taken by the Trustee.

STATEMENT OF JURISDICTION

The Appellant, Sam Kleinman, filed a claim in said bankruptcy proceedings, which are pending in the District Court of the United Staes for the Southern District of California, Central Division, in the sum of $127,501.61, composed as follows: $126,401.61 Secured; $350.00 Unsecured; and $750.00 Unsecured, for which a priority claim was filed. (Tr. 7 to 15.)

Objections to said claim and to the security thereunder and asserting offsets to said claim were filed by Paul W. Sampsell, Trustee of the Estate of the Bankrupts in said proceedings. (Tr. 15 to 24.) After a hearing on the issues raised by said Objection, the Referee found in favor of the Appellee. (Tr. 25 to 35.)

From the Order of the Referee dated the 17th of January, 1941 (Tr. 36, 37) Appellant filed a Petition

for Review. (Tr. 37 to 44.) After the Referee's Certificate on Petition for Review (Tr. 44 to 55), the Order of February 17, 1941, was submitted to the United States District Court, and said District Court made its Order, dated June 8, 1942 (Tr. 81, 82), which reversed the Findings of Fact and Conclusions of Law of the Referee as to all offsets for alleged usury, and affirmed that portion of said Order which held the claim of the Appellant to be an unsecured claim, and reversed said Order of the Referee dated the 17th day of January, 1941, with respect to said claimed offsets for alleged usury.

This appeal is brought to review that portion of the final Order of the District Court of the United States for the Southern District of California, Central Division, dated June 8, 1942 (Tr. 81, 82), which adjudges Appellant's claim to be unsecured.

The jurisdiction of this Court to review the Order of the District Court is found in the provisions of Sections 24a and 24b of the National Bankruptcy Act (Title 11, Sections 47 and 48 U. S. C. A.) and Title 28, Section 225c U. S. C. A.

Section 24a provides, "The Circuit Courts of Appeal of the United States . . . are hereby invested with appellate jurisdiction from the several courts of bankruptcy in their respective jurisdictions in proceedings in bankruptcy, either interlocutory or final, and in controversies arising in proceedings in bankruptcy, to review, affirm, revise, or reverse, both in matters of law and in matters of fact. . . ."

Section 24b provides, "such appellate jurisdiction shall be exercised by appeal and in the form and manner of an appeal."

It appears on the face of the record that the amount involved in this appeal is more than Five Hundred ($500.00) Dollars (Tr. 82 and 84).

The jurisdiction of the Referee of the District Court to hear, and allow the objections of the Appellee is found in Sections 23 and 38 of the National Bankruptcy Act, (Title 11, Section 46; Section 66; U. S. C. A.)

Section 23a provides, "The United States District Courts shall have jurisdiction of all controversies at law and in equity, as distinguished from proceedings under this Act, between receivers and trustees as such and adverse claimants, concerning the property acquired or claimed by the receivers or trustees. . . ."

Section 23b provides, "Suits by the receiver and trustee shall be brought or prosecuted only in the courts where the bankrupt might have brought or prosecuted them if proceedings under this Act had not been instituted, unless by consent of defendant, except as provided in Sections 60, 67, and 70 of this Act."

Section 38 provides, "Referees are hereby invested, subject always to a review by the judge, with jurisdiction to . . . (6) perform such of the duties as are by this Act conferred on courts of bankruptcy. . . ."

The jurisdiction of the District Court to review the Order of the Referee is found in Section 39c of the

National Bankruptcy Act. (Title 11, Section 67, U. S. C. A.)

Section 39c provides, "A person aggrieved by an order of a referee may, . . . file with the referee a petition for review of such order by a judge. . . ."

STATEMENT OF THE CASE

For many years prior to the proceeding herein, the bankrupts operated two pawnbroking establishments in Los Angeles, California, to wit: the "Provident Loan Association" and the "State Loan Office." During this period they also owned and operated numerous entertainment enterprises in California, Nevada and Montana.

As early as 1925, Appellant had loaned substantial sums to the bankrupts. These sums had all been repaid prior to 1933. During 1933 and 1934, Appellant loaned $30,500.00 to the bankrupts. In 1935, he loaned them an additional $19,500.00.

In 1935, the bankrupts hired the Appellant to work at Provident Loan Association as an expert gem appraiser and salesman. (Tr., p. 441.)

In 1936, the bankrupts borrowed an additional $20,000.00 from Appellant. In 1938, Appellant loaned them further sums totaling $25,700.00. These loans totaled $95,700.00 by the end of 1938, and were evidenced by unsecured promissory notes of the bankrupts.

On February 24, 1939, the $95,700.00 notes were cancelled (Tr. 111 to 112) and other notes, amounting

to $3,669.00, of the bankrupts were likewise cancelled, and Appellant advanced cash in the sum of $631.00. Twenty $5,000.00 notes, totaling $100,000.00, were then executed by the bankrupts and delivered to Appellant and an agreement was executed. (Copies of these notes and of the contract of February 24, 1939 (Defendant's Exhibit 4, Tr. 110 to 134), are attached to Appellant's claim.) By the agreement the bankrupts assigned to the Appellant, as security for the repayment of said notes, certain designated and numbered pawn tickets, which the bankrupts had received from their customers, and which represented approximately $107,000.00 due the bankrupts from those customers. These pawn tickets were in effect promissory notes (Tr. 255 to 260). The agreement provided that bankrupts would act as appellant's agent for collection of the money due on the pawn tickets.

On March 1, 1939, Appellant and the bankrupts entered into an oral agreement by the terms of which the bankrupts were given the right to use the money collected and to be collected on the assigned pawn tickets under the following conditions: that said bankrupts were required to use said collected money only for new loans to their customers; and to substitute the pawn tickets acquired by their loan of Appellant's money as security in the place and instead of the redeemed pawn tickets. (Tr. 224 to 225, 246, 266, 268, 291, 453, 454.)

This agreement was carried out. At intervals of from three days to a week, these replacement pawn

tickets, which had been accumulating, were (in an amount equaling those redeemed), by written agreements, formally assigned to Appellant. (Tr. 291, 317, 338, 364, 377, 433.) New notes were executed in the amount of these redemptions, and the numbers of the new pawn tickets were attached to said agreements. The substitution agreements varied from $1200.00 to $4600.00 in amount, depending on the quantity and rate of the redemptions. (Copies of these notes and agreements are attached to Appellant's claim.) Appropriate credit entries were indorsed upon the notes and in the bookkeeping record of the bankrupts. (Tr. 373, 374.) All moneys collected by bankrupts on the pawn tickets assigned to Appellant were in this manner reloaned. (Tr. 246, 266, 268, 291, 292, 315, 507.)

On two different occasions, to accommodate the bankrupts, the Appellant exchanged a portion of his tabulated and assembled pawn tickets for an equal value of others of the bankrupts. (Tr. 319 to 324; 332 to 334; 454, 455, 459, 460.)

In addition to the foregoing, between May 2, 1939, and July 10, 1939, Appellant loaned the bankrupts the additional sum of $8350.00, which was secured by similar notes, agreements, and pawn tickets (Tr. 547, 554).

Between February 24, 1939, and July 10, 1942 (on which latter date a petition in reorganization was filed by the bankrupts), the money received by the bankrupts from the redemption of the pawn tickets assigned to the Appellant amounting to $44,915.00

(Tr. 540, 541), and the additional $8350.00 loaned by Appellant, totaled $53,265.00. The amount of money loaned out by bankrupts during the same period was $55,120.37. (Tr. 541.)

THE QUESTIONS INVOLVED

I.

Were the agreements between the appellant and the bankrupts, providing for an assignment of pawn tickets as security, valid and enforcible?

II.

Did the bankrupts have unrestricted and unfettered dominion over the proceeds of the assigned pawn tickets?

III.

Was the estate of the bankrupts diminished by assignments to the appellant?

IV.

Did the appellant as a creditor of the bankrupts have reasonable cause to believe that the bankrupts were insolvent?

STATEMENT OF POINTS RELIED UPON ON APPEAL

Appellant respectfully relies in the appeal before this Court upon Points I, II, III, IV, V and VI, as the same appear in the Transcript of Record, pages 581 to 584, inclusive.

However, in conformity with Rule 20 (d), each of the said errors relied upon are set forth herein in full.

(1) That portion of the Order of the Judge on Petition for Review of Referee's Order dated June 8, 1942, which adjudges and decrees that the claim of Sam Kleinman is a general unsecured claim and not a secured claim, is contrary to the law and is not supported by the evidence.

(2) That the District Court erred in making that portion of its Order, dated June 8, 1942, adopting and approving the following Findings of Fact of the Referee, for the reason that the same are against the law and not supported by the evidence:

(a) That on February 24, 1939, and for sometime prior thereto, and continuously thereafter, Sam Kleinman had reasonable cause to believe, and did know, that the bankrupts, as co-partners, and as individuals, were insolvent.

(b) The pledge agreements, pledge property and pawn tickets remained in the possession and under the control of the bankrupts.

(c) That the money received from the customer would be placed in the cash drawer and used again in the business of the bankrupts, without segregating it in any manner.

(d) The moneys received as a result of the redemption of pledges by customers became a part of the general funds of the bankrupts, and that Sam Kleinman had full knowledge of this procedure and acquiesced to it.

(e) There never was a transfer of the pawn tickets or pledges, and that all of the property and assets at all times remained in the exclusive possession and control of the bankrupts, and that Sam Kleinman did not exercise any dominion or control over the pledges or the pledge ticket stubs, except as an employee of the bankrupts.

(f) That the bankrupts at all times had exclusive dominion and control of the pledge ticket stubs and pledges, and that there was not any difference in the handling of the pledges or pledge tickets after they were assigned to Sam Kleinman for security than there was before that time.

(g) That the transfer of the pledges and pledge ticket stubs from the bankrupts to Sam Kleinman was a fiction, and that no actual transfer ever took place.

(h) That the transaction between the bankrupts and Sam Kleinman was an attempt to give

Sam Kleinman a more favorable position over other creditors.

(i) That the checks executed by Sam Kleinman's daughter, Jeanette Dienstag, and delivered to the Bankrupts in respect to new notes and contracts, was a subterfuge, as the sums of money indicated were not actually paid to the bankrupts.

(j) That the claimant knew that in 1936 and 1937 there was sufficient money to make loans, and that after that time he knew there was not sufficient money to make all loans requested by customers; and that he also knew that many large loans were refused because the bankrupts were short of capital.

(k) That a duplicate set of pawn ticket stubs were not segregated from the rest of the records of the bankrupts.

(3) That the District Court erred in approving and adopting the following Conclusion of Law of the Referee:

That the assignment of pledge tickets and pledges from the bankrupts to Sam Kleinman was void as against the creditors of the bankrupts and as against the Trustee in bankruptcy.

(4) That the District Court erred in making its order adjudging and decreeing that the said claim of Sam Kleinman is a general unsecured claim (rather than a secured claim).

(5) That the District Court erred in failing to find that the claim of Sam Kleinman was a secured claim in the sum of $108,350.00, plus interest accrued at the date of the proof of claim, i.e., the 14th day of February, 1940, together with interest at the rate of 10% from and after said 14th day of February, 1940.

(6) That the District Court erred in failing to find that the claimant was entitled to reasonable attorneys' fees in this matter by virtue of his security agreement.

SUMMARY OF ARGUMENT

I.

An assignment of pawn tickets by a pawnbroker in the State of California, as security for the repayment of an obligation is valid and enforcible.

II.

The validity of the assignments was not affected by the permission granted to the Bankrupts to collect the proceeds and reloan the same upon substitution of equal security, nor did the Bankrupts have unfettered dominion or control over the pawn tickets or their proceeds.

III.

The assignments of the pawn tickets after March 2, 1939, were not preferential for the reason that they were substituted for other pre-existing security and no diminution of the Bankrupts' estate resulted.

IV.

The assignments to the Appellant cannot be deemed preferential for the reason that the evidence does not support the findings of the Referee and the District Court; that on February 24, 1939 (date of first contract of assignment), and for sometime prior thereto and continuously thereafter, Sam Kleinman (Appellant) had reasonable cause to believe and did know that the bankrupts as co-partners and as individuals were insolvent.

ARGUMENT

I.

AN ASSIGNMENT OF PAWN TICKETS BY A PAWNBROKER IN THE STATE OF CALIFORNIA AS SECURITY FOR THE REPAYMENT OF AN OBLIGATION IS VALID AND ENFORCIBLE.

The subjects of the assignment agreements between the appellant and the bankrupts were the pawn tickets (Tr. 113). An examination of a copy of these pawn tickets (Tr. 255 to 260) discloses that it was a promise on the part of the bankrupts' customers to pay to the bankrupts a stated sum of money and as such was a chose in action. A chose in action is defined by the Civil Code of the State of California, Sec. 953, as "A right to recover money or other personal property by a judicial proceeding." Under the law of the State of California a pawn ticket is clearly a chose in action and is enforcible by an action at law.

Mauge v. Heringhi, 26 Cal. 577;

Turney v. Goldberg's Loan Office, 274 Pac. 464, 135 Okla. 147.

It is definitely settled that the validity of a security agreement whenever the same is questioned in bankruptcy must be determined by the law of the State where the contract is made. In the case at bar all of the agreements were made and executed in California and consequently the law of that state governs.

Hiscock v. Varick Bank of New York, 206 U. S. 28; 27 S. Ct. 681; 51 L. Ed. 945.

Section 3440 of the Civil Code of California provides as follows:

> "Every transfer of personal property, *other than a thing in action* . . . is conclusively presumed, if made by a person having at the time the possession or control of the property, and not accompanied by an immediate delivery, and followed by an actual and continued change of possession of the things transferred, to be fraudulent, and therefore void, against those who are his creditors. . . ." (Italics ours.)

Under this section of the Civil Code, in California an assignment in writing of choses in action is valid and effective without a delivery or a change of possession of the instruments evidencing the obligations transferred. The decisions firmly establish this proposition.

Kirk v. Roberts, 3 Cal. Unrep. 671; 31 Pac. 620;

Merced Bank v. Price, 9 Cal. App. 177; 98 Pac. 383;

Burkett v. Doty, 176 Cal. 89; 167 Pac. 518;

Joint Pole Association v. Steele, 213 Cal. 233; 2 Pac. (2d) 157;

Kent v. Kent, 6 Cal. App. (2d) 488; 44 Pac. (2d) 445;

3 Cal. Jur. (Assignments), Sec. 21, p. 265.

II.

THE VALIDITY OF THE ASSIGNMENTS WAS NOT AFFECTED BY PERMISSION GRANTED TO THE BANKRUPTS TO COLLECT THE PROCEEDS AND RELOAN THE SAME UPON SUBSTITUTION OF EQUAL SECURITY, NOR DID THE BANKRUPTS HAVE UNFETTERED DOMINION OR CONTROL OVER THE PAWN TICKETS OR THEIR PROCEEDS.

In approaching this phase of the argument, the attention of the Court is respectfully directed to the case of Benedict v. Ratner, 268 U. S. 353; 45 S. Ct. 566; 69 L. Ed. 991. In this case, at page 364, the Supreme Court set forth the guiding principles for the determination of the validity of those security transactions in which the debtor collects on behalf of the creditor the proceeds or liquidation of the security. It was there stated as follows:

> ". . . If the agreement is that the mortgagor may sell and use the proceeds for his own benefit, the mortgage is of no effect, although recorded . . . *but it is only where the unrestricted dominion over the proceeds is reserved to the mortgagor that the mortgage is void. This dominion is the differentiating and deciding element.* . . ." (Italics ours.)

The theory of the Court is described in the following language at page 363:

> "The nature of the rule is made clear by its limitations. Where the mortgagor of chattels agrees to apply the proceeds of their sale to the payment of the mortgage debt or to the purchase of other chattels which shall become subject to the lien, the mortgage is good as against creditors if recorded. . . . The permission to use the proceeds to furnish substitute collateral 'provides only for a shifting of the lien from one piece of property to another taken in exchange.' . . ."

We respectfully urge that under this rule and its elaboration in the cases hereinafter to be cited, the facts of the instant case are such that but one conclusion may be drawn, to wit, that neither unrestricted nor unfettered dominion or control was reserved to the bankrupts under the arrangement with the appellant, but that their conduct in respect to the pawn tickets and the proceeds derived from the collection thereof was definitely circumscribed and limited.

It is our contention that the uncontroverted facts fully show that appellant permitted the bankrupts to use the proceeds of his security solely to furnish substitute collateral and that thereby there was only "a shifting of the lien from one piece of property to another taken in exchange."

We have printed in the Appendix, pages 83 to 145, all of the testimony of the parties, which is materially related to this point. From this evidence, it appears, without question, that the Appellant did not permit the bankrupts to have unfettered dominion or control over the pawn tickets or their proceeds, but in fact, himself maintained such dominion and control as is required under the law.

The elements of restraint imposed by the Appellant are enumerated as follows:

1. Until the time when the agreement of February 24, 1939, was modified by the agreement of March 1, 1939, the bankrupts held all money received under the contract segregated and in trust for Appellant. (Appendix, pages 103 to 105, 116.)

2. The use of money collected by the bankrupts on the contract, after March 1, 1939, was limited solely to reloans upon substituted pawn tickets, all of which were by agreement security for Appellant. (Appendix, 103 to 115, 118 to 120.)

3. After March 1, 1939, it was a continuous duty of the bankrupts to, and they did set aside and accumulate pawn tickets for Appellant in substitution and

replacement of his redeemed pawn tickets. (Appendix, pages 113 to 114.)

4. At frequent intervals, varying from two days to a week, Appellant required the bankrupts to, and they did cause the accumulated pawn tickets to be formally listed and incorporated into written contracts. (Appendix, pages 106 to 108, 110, 111, 113 to 115.)

5. The bankrupts daily accounted to Appellant with reference to the disposition of the proceeds of the assigned pawn tickets, and maintained a permanent running inventory thereof and furnished copies thereof to Appellant. The bankrupts kept a ledger record, a copy of which was furnished by them to Appellant, upon which the bankrupts were required to and did maintain a record of the credits and debits existing between the bankrupts and Appellant. (Appendix, pages 130 to 134, 140 to 144, Plaintiff's Exhibit 5, Tr. 371, 372.)

6. Immediately on the execution of the first contract and continuously thereafter, all of the pawn tickets listed in the contracts between the Appellant and the bankrupts were removed from the binders of the bankrupts and were placed in special binders marked "K" to indicate that they were Appellant's pawn tickets. These pawn tickets were kept separate from the pawn tickets of the bankrupts. (Appendix, pages 97 to 103, 113, 114, 122, 123.)

7. Contemporaneously, the tangible pawns relating to those pawn tickets were segregated, making them

more readily identified and redeemable with relation to the assigned pawn tickets. (Appendix, pages 92 to 97.)

The doctrine of Benedict v. Ratner, supra, pages 14, 15, does not appear to have been presented to this Court. Its application, however, has received consideration in other circuits, and it appears to be well settled that the contracts and the manner of their performance between the bankrupts and the Appellant are valid.

Clark v. Iselin, 88 U. S. 360; 22 L. Ed. 568;

Sexton v. Kessler, 225 U. S. 90; 32 S. Ct. 657; 56 L. Ed. 995;

Young v. Upson, 115 Fed. 192 (2 Circ.);

Chapman v. Emerson, 8 Fed. (2d) 353 (4 Circ.);

Coppard v. Martin, 15 Fed. (2d) 743 (5 Circ.);

In re Federal Piano Corporation, 37 Fed. (2d) 556 (4 Circ.).

In Young v. Upson, 115 Fed. 192 (2 Circ.) at p. 194, it appeared that the bankrupt had delivered to the creditor assignments in writing of its accounts receivable as collateral security. The books of the company indicated the assignment. In determining that the security was valid, the Court stated at page 195 in the opinion, as follows:

> "I am unable to perceive how a pledge of bills receivable could have been transferred more ef-

fectively in the absence of a statute requiring notice to be given than was actually done in the case at bar. Separate accounts were carried on the books of the Company. The proceeds of accounts collected were immedately paid to the lender. Requests for renewal notes and extension of time of payment were referred to complainant for his decision. His right of possession is as fully demonstrated as the nature of the security would permit. But it is contended that it is essential to the validity of the transfer that notice should have been given to the debtors whose claims were assigned. This contention is unsound. The necessity for notice by an assignee to the debtor arises where he seeks to protect himself against a payment by the debtor to the original creditor. The debtor is released from liability to the assignee unless he has been notified of the assignment."

In the case of Chapman v. Emerson, 8 Fed. (2d) 353 (4 Circ.), the bankrupt assigned to the creditor its accounts which were to be collected by the bankrupt and the proceeds paid over to the creditor. In determining the conflicting claims of the creditor and the trustee in bankruptcy, the Court stated at page 354, as follows:

"The same individual was a representative of the appellees and an active officer of the bankrupt. When the latter collected assigned accounts, it did not always turn over the proceeds to the appellees. In fact, it usually replaced the collected accounts by others of later date. In some in-

stances, it is probable not even so much was done. The relations between the bankrupt and the appellees were such that what they did was more significant than what they said they were going to do. The referee and the learned District Judge were right in critically scrutinizing their transactions. In the result, however, they united in the conclusion that the assignment was made in good faith for present consideration, and that, although the appellees had not always insisted on the full measure of their rights, they had never intended to surrender, and had not in fact surrendered, to the bankrupt anything approaching 'unfettered dominion' over the accounts or their proceeds."

In Coppard v. Martin, 15 Fed. (2d) 743 (5 Circ.), defendant lent the bankrupt, a corporation, $4500.00 for the purpose of purchasing certain outstanding stock, and under an arrangement whereby the defendant was made manager of the business, and that his loans should be repaid out of the first proceeds from the sale of the goods of the corporation. In an action brought by the trustee in bankruptcy attacking the validity of the transfer the Court declared, at page 745:

"We are of opinion that a valid lien was created. The pledge of accounts receivable of a mercantile business creates a lien, though such accounts be retained and collected by the pledgor, and substitutions of future accounts be authorized. Van Iderstine v. National Discount Company, 227 U. S. 575; 33 S. C. T. 343; 57 L. Ed. 652; Sexton v. Kessler, supra.

"However, if the pledgor is not required to make substitutions, but is authorized to use the proceeds of accounts as he sees fit, no lien exists. Benedict v. Ratner, 268 U. S. 353; 45 Supreme Court 566; 69 L. Ed. 991. A pledge of accounts receivable being sufficient to create a lien, we think it must follow by analogy that a pledge of money received from the sale of goods is also sufficient for that purpose, for the principle is the same. The necessity of surrender of dominion by the pledgor applies to the tangible property, but it does not apply to a pledge of indebtedness. See Young v. Upson (C. C.), 115 Fed. 192, cited with approval by the Supreme Court in Benedict v. Ratner, supra. Consequently, Article 4000, Texas Revised Civil Statutes, which in effect makes void a lien upon a stock of goods exposed for sale in the regular course of business, where possession and control remain in the owner of the goods, has no application to the pledge of accounts receivable or proceeds from the sale of goods.

"Martin's lien was not lost by reason of his failure to reimburse himself out of the first moneys received from the sale of goods. The acquiescence of the corporation that he reimburse himself out of later receipts amounted to a substitution, and did not result in any injury to the general creditors represented by the trustee."

In the case of in re Federal Piano Corporation, 37 Fed. (2d) 556, (4 Circ.), it appeared that the bankrupt assigned to the defendant certain conditional sales contracts and leases as security, the agreement providing that the bankrupt should collect the install-

ments due and apply them upon the notes at sixty day intervals. The Court sustained the validity of this transaction, stating as follows at page 556 of the opinion:

> "The trustee insists, however, that this transaction was fraudulent in law *because the bankrupt was permitted to continue to collect the installments due and to mingle the same with its own funds* without accountability until the end of each of the sixty day periods, and the referee has held with him, and both rely upon Benedict v. Ratner, 268 U. S. 353; 45 Supreme Court 566, 567; 69 L. Ed. 991. I have examined that case carefully, with the result that I find it dependent upon wholly different facts from the case at bar. In that case, there was an assignment of accounts receivable as in this. 'The receivables were to be collected by the company. Ratner was given the right, at any time, to demand a full disclosure of the business and financial conditions; to require that all amounts collected be applied in payment of his loans; and to enforce the assignment although no loan had matured. *But until he did so, the company was not required to apply any of the collections to the repayment of Ratner's loan. It was not required to replace accounts collected by other collateral of equal value. It was not required to account in any way to Ratner. It was at liberty to use the proceeds of all accounts collected as it might see fit.* The existence of the assignment was to be kept secret.' *The difference between those facts and those which are shown in this case are obvious. Here the bankrupt was*

required to apply all collections made within every sixty day period to the curtailment of the note, and, while it is true it had the use of the money collected between the date of collection and maturity of the notes, it was as of the latter date required to pay it over in payment of the curtail, and as between the two every dollar collected was ear-marked for the specific purpose mentioned. . . .

"The test in all such cases seems to be whether the assignor retains unfettered dominion over nominally assigned accounts and their proceeds. If so, the assignment is fraudulent. Otherwise it is not.

"I cannot say the evidence here shows such 'unfettered dominion' over the accounts or their proceeds, and I find myself therefore obliged to reject the conclusions of the referee and reverse the order entered by him." (Italics ours.)

From these decisions, the following propositions are clearly enunciated:

1. A creditor may take an assignment of choses in action, notes, bills due, or accounts, as security for an obligation under an agreement whereby his debtor is substituted as an agent for the purpose of collection.

2. Adequate "fettering" of the debtor exists in law if he must, upon collection or at agreed periods, account to the creditor for the collected proceeds, and pay the same or substitute other security in lieu thereof. Measured by these criteria, it is respectfully sub-

mitted that the contracts and the conduct of the appellant and the bankrupts, fall well within these rules, and are valid and bind the Trustee in Bankruptcy.

III.

THE ASSIGNMENTS OF THE PAWN TICKETS AFTER MARCH 2, 1939, WERE NOT PREFERENTIAL FOR THE REASON THAT THEY WERE SUBSTITUTED FOR OTHER PRE-EXISTING SECURITY AND NO DIMINUTION OF THE BANKRUPTS' ESTATE RESULTED.

The testimony of the parties discloses that an oral contract was entered into on March 1, 1939, wherein it was agreed between appellant and the bankrupts that the bankrupts could use the moneys collected by them in respect to the appellant's pawn tickets solely for re-loans to the customers of the bankrupts, and that the pawn tickets thereafter coming into their possession and representing the proceeds of the appellant's security so re-loaned should stand in the place and stead of said proceeds. (Appendix, 103-115.) This arrangement is approved by the decisions, the leading case being Sawyer v. Turpin, 91 U. S. 114, 23 L. Ed. 235.

The Court there states the principle, as follows, at page 120 of the opinion:

> "It is too well settled to require discussion, that an exchange of securities within the four months is not a fraudulent preference within the

meaning of the Bankrupt Law, even when the creditor and the debtor know that the latter is insolvent, if the security given up is a valid one when the exchange is made, and if it be undoubtedly of equal value with the security substituted for it. . . . The reason is, that the exchange takes nothing away from the other creditors."

The case of Sawyer v. Turpin has received express approval in the Ninth Circuit. Roberts v. Yegen, 12 Fed. (2d) 654 (9 Circ.). Other cases directly illustrating the general rule are as follows:

Sexton v. Kessler, 225 U. S. 90, 32 S. Ct. 657, 56 L. Ed. 995;

In re Reese-Hammond Fire Brick Co., 181 Fed. 641 (3 Circ.);

Union Trust Co. v. Bulkeley, 150 Fed. 510 (6 Circ.);

Union Trust Co. of Maryland v. Townshend, 101 Fed. (2) 903 (4 Circ.), (Cert. den. 307 U. S. 646);

Chapman v. Hunt, 254 Fed. 768 (2 Circ.);

Burrowes v. Nimocks, 35 Fed. (2d) 152 (4 Circ.);

Greey v. Dockendorff, 231 U. S. 513; 34 S. Ct. 166; 58 L. Ed. 339;

Okin v. Isaac Goldman Co., 79 Fed. (2d) 317 (2 Circ.).

In Greey v. Dockendorff, 231 U. S. 513, 33 S. Ct. 166, 58 L. Ed. 339, it appeared that the bankrupt, a

cotton converter, borrowed, over a period of time, approximately $253,000.00 from a creditor, giving as security therefor its future accounts receivable. By the agreement, the creditor's lien was to be for all sums due and to cover all accounts.

In rejecting the contention of the trustee in bankruptcy that the assignment was invalid, the court stated at page 515 of the opinion:

> "The question here is whether successive assignments of accounts by way of security, in pursuance of a contract under which advances were made to enable the assignor to get the goods on the faith of the undertaking that the accounts should be assigned, were bad because the contract embraced all accounts, although neither party contemplated any fraud. The rule of the English statutes as to reputed ownership may extend to debts growing due to the bankrupt in the course of his business, but we have no such statute. *The advances were the means by which the bankrupt got the ownership of the goods. The contract of itself would operate as a conveyance as soon as the rights to which it applied were acquired.* Field v. New York 6, New York 179. We do not see why in the interval between the acquisition of the goods and the specific assignment of accounts, the right of general creditors without lien should intervene to defeat a security given in good faith, when, but for the promise of it, the property never would have come into the bankrupts hands. There may have been a moment when the goods could have been attached, or when, if insolvency had been made known, as in National City Bank vs. Hotch-

kiss, ante P. 50, it would have been too late to make the promised lien good. But in this case, the lien was acquired before any knowledge of insolvency, and before any attachment intervened. See Jaquith v. Alden, 189 U. S. 78; Coder v. Arts, 213 U. S. 223; Van Iderstine v. National Discount Co., 227 U. S. 575, 583. It is objected that this lien was secret. But notice to the debtors was not necessary to the validity of the assignment as against creditors. Williams v. Ingersoll, 89 N. Y. 508, 522, and merely keeping silence to the latter, whether known or unknown, created no estoppel. Weiser v. Lawler, 189 U. S. 260, 270; Ackerman v. True, 175 N. Y. 353, 363. There was no active concealment and no attempt to mislead anyone interested to know the truth."

The record in this case indicates that between February 24, 1938, and the date of the bankruptcy, the bankrupts collected $44,915 upon the pawn tickets assigned to the appellants. (Appendix, page 118.) During that period the appellant had loaned to the bankrupts an additional sum of $8,350.00. (Appendix, page 117.) It further appears that during this period the bankrupts loaned out a total of $55,120.37. (Appendix, page 180.) Therefore, the appellant furnished over 96% of the moneys available for loaning by the bankrupts to its customers. Under these facts, the appellant should have a favored standing as a secured creditor in a court of bankruptcy.

Greey v. Dockendorff, supra, pp. 25-27.

In the case of Okin v. Isaac Goldman Co., 79 Fed. (2d) 317 (2 Circ.), the bankrupt, a publisher, assigned to the defendant as security for present and future indebtedness an account due from American News Company. A second assignment was made by the bankrupt of an account due from Public News Company. These assignments were executed more than four months before the date of bankruptcy. Within the four months' period, the defendant received payments from the American News Company for credits it had advanced to the bankrupts for printing. With reference to the payments from the Public News Company, these represented current credits the defendant had advanced in connection with the issues of the bankrupts' magazines within the four months' period. The trustee in bankruptcy sought to recover all of these payments as voidable. At page 320 of the opinion, the Court states:

> "The Circuit Court of Appeals for the Sixth Circuit, in Union Trust Company v. Bulkeley, 150 F. 510, at p. 516, held that:
>
>> 'A parol assignment of an account and bills receivable to be acquired in the course of business by the assignor, given in order to furnish security, though relating to after-acquired property, created a valid lien upon the property, the Court saying: "When acquired, it would become subject to the lien without any new or further agreement. This is something quite different from an execu-

tory contract." . . . Union Trust Company v. Bulkeley, supra . . . while dealing specifically with the common law of Michigan, in our opinion sets forth the common law of New York as well as England, in relation to the time when liens created by an assignment of after-acquired accounts will take effect. It seems particularly pertinent because of its statement that they will take effect when the accounts are acquired by the bankrupt "without any new or further agreement."

'In view of the foregoing, the payments to the defendant by the American News Company, in our opinion, created no preference irrespective of whether or not they were upon an antecedent indebtedness to the latter or in liquidation of advances made after April 8, 1931, when the assignment was executed. This is because all of the accounts covered by the assignment arose outside of the four months' period. Sexton v. Kessler & Co., 225 U. S. 90; Voltz v. Treadway, 59 F. (2) 643; Goldstein v. Rusch, 56 F. (2) 10; Union Trust Co. v. Bulkeley, 150 F. 510.

'The assignment of the account against the Public News Company and the payments to the defendant thereunder created no unlawful preference, but for a different reason . . . while the accounts against the Public News Company for the September issue may in whole or in part have arisen prior to the four months' period, the account for the October

issue certainly arose within that period. These considerations, however, cannot affect the result or render the payments preferential. . . . *So far as they were made from accounts which arose within the period, they were in liquidation of security given by the bankrupt to obtain future advances of credit from the defendant.* As we have already stated, the lien took effect when the accounts against Public News Company came into being. The advances, when made, furnished a present consideration for the imposition of the liens. The decision of In re Bernard & Katz, Inc., (C. C. A.) 38 F. (2), 40, 43, had to do with such a situation. There, Swan, J., remarked: '*When the parties agree in good faith that a lien presently created shall stand as security for future advances, and such advances are thereafter actually made in good faith before the bankruptcy of the borrower, we see no reason to deny effect to the agreement. . . . The future advance, when made, becomes a present consideration; it increases the borrower's assets by as much as the enlargement of the lien decreases them.*'

In re Locust Bldg. Co. (C. C. A.), 299 F. 756, 769, is to the same effect. Although the accounts against the Public News Company were not in existence when the assignment was made as was the security In re Bernard & Katz, supra, there was no depletion of the estate caused by the payment, inasmuch as it was given in exchange for the magazines printed at the cost of the defendant, and furnished to Quality Publication, Inc., at the

same time when the assignment actually took effect. Indeed, the account of Public News Company was but a substitute for the magazine. Accordingly, the fact that the payment was made during the four months' period can make no difference, because it was derived from the accounts which were a present consideration for the delivery of the magazine." (Italics ours.)

IV.

THE ASSIGNMENTS TO THE APPELLANT CANNOT BE DEEMED PREFERENTIAL FOR THE REASON THAT THE EVIDENCE DOES NOT SUPPORT THE FINDINGS OF THE REFEREE AND THE DISTRICT COURT: THAT ON FEBRUARY 24th, 1939 (DATE OF FIRST CONTRACT OF ASSIGNMENT), AND FOR SOMETIME PRIOR THERETO AND CONTINUOUSLY THEREAFTER, SAM KLEINMAN (APPELLANT) HAD REASONABLE CAUSE TO BELIEVE AND DID KNOW THAT THE BANKRUPTS AS CO-PARTNERS AND AS INDIVIDUALS WERE INSOLVENT.

In approaching this phase of the argument, we desire to state at the outset that we are not unmindful of the rule prevailing in this jurisdiction to the effect that this court will not reverse the findings of the Referee and the District Court, except for manifest error.

Ott v. Thurston, 76 Fed. (2d) 368 (9 Circ.);

Weisstein Brothers v. Laugharn, 84 Fed. (2d) 419 (9 Circ.).

It is, however, the rule in this circuit that where obvious error has occurred in the application of the law to the facts, or in the consideration of the facts, or if there is no substantial evidence to support the decision, the propriety of the findings is open to question.

Hunter v. McFarlane, 45 Fed. (2d) 994 (9 Circ.);

Harris v. Prudential Insurance Co. of America, 78 Fed. (2d) 849 (9 Circ.).

This Court has not hesitated to reverse the finding of the Referee, affirmed by the District Court, that a creditor knew or had reasonable cause to know of the insolvency of the debtor, where such finding was not justified by the evidence.

Valley National Bank v. Westover, 112 Fed. (2d) 61 (9 Circ.) (Cert. den. 311 U. S. 675.).

In the Appendix, pages 1 to 83, the material testimony pertaining to the question of knowledge of insolvency is set forth. We believe that a reading of this testimony discloses that the following are the essential facts concerning Appellant's knowledge of the financial condition of the bankrupts.

The bankrupts owned two pawn-broking establishments in Los Angeles, California, and approximately ten amusement and other enterprises in the states of California, Nevada and Montana, and considerable real estate in Glendale, Redondo Beach and San Mateo

County, California. The Glendale property alone represented an investment of $120,000.00 on the part of the bankrupts. (Appendix, pages 63, 68 to 76.)

In the pawn-broking business the bankrupts owned large quantities of merchandise, consisting of gems, gold, platinum and other jewelry, and unredeemed pledges, valued at hundreds of thousands of dollars. Part of these assets were displayed in show cases and the remainder were stored in vaults located in the two loan establishments. (Appendix, pages 56 to 65.)

The bankrupts were in the business of loaning money as pawnbrokers, and loans earned interest at the rate of from two to three per cent per month, depending on the size of the loan. (Appendix, 57, 58, 63.) The security for their loans was ample to protect them against loss of principal and interest; in the event of default on the part of their customers, they were able to and did sell the forfeited pawns at a profit. (Appendix, 65 to 67.) Ordinarily when business was good, the bankrupts' money was "working," that is, all "loaned out." Generally they were short of cash, and that indicated that business was good, and until the date of bankruptcy, no contrary indication appeared. (Appendix, pages 22 to 24.) From at least 1932 on the bankrupts were always borrowing money. (Appendix, pages 32, 47.)

The bankrupts did not conduct their affairs in a businesslike manner. They did not at any time know the extent of the value of their merchandise or other

assets. They had no inventory of these assets. They did not know either the amount of their liabilities or the amount of their assets at any time prior to the filing of their schedules in bankruptcy. They did not know the financial condition of their business at any time prior to the date of bankruptcy. (Appendix, pages 76 to 82.)

The appellant had known the bankrupts for approximately twenty-five years prior to bankruptcy. (Appendix, page 3.) Fourteen years before the date of bankruptcy, appellant commenced loaning them substantial sums of money. (Appendix, pages 2 and 3.) Four years before the date of bankruptcy, appellant was employed by the bankrupts as a gem appraiser at Provident Loan Association, one of their pawnbroking establishments in Los Angeles, earning $75.00 per week and 1% commission on his sales. (Appendix, pages 4, 5.)

At frequent intervals during all of appellant's contact with the bankrupts from 1936, and somewhat more often during the last six months before the filing of the petition in bankruptcy, the cash drawer of the bankrupts from which money was taken for loans to customers, contained insufficient cash for that purpose. (Appendix, pages 33 to 38, 46.) On many occasions from 1936 on, the appellant advanced sums of money from $100 to $15,000 in amount, taking the bankrupts' I.O.U.'s in order that they might replenish their cash drawer for making loans. (Appendix, pages 54 to 55.) Appellant knew that on many occa-

sions one of the clerks at the Provident Loan Association would telephone to the other pawnbroking establishment of the bankrupts for money to restock the cash drawer. (Appendix, pages 33 to 34.)

As early as 1936, the volume of merchandise on hand for sale at the Provident Loan Association diminished and the appellant's duties as a gem appraiser changed at that period. Thereafter he acted partly as a loan clerk. (Appendix, page 5.) In that work he became familiar with the contents of the cash drawer, and of the loaning and reloaning of the bankrupts' cash. (Appendix, pages 5, 19 to 21.)

The history of appellant's loans to bankrupts is as follows: From 1925 to 1933, loans in $10,000, $15,000 and $20,000 amounts were made and repaid. (Appendix, page 3.) In 1933 or 1934, appellant loaned the bankrupts $30,500.00. In 1935, appellant loaned them an additional $19,500.00. In 1936, appellant loaned the bankrupts sums totaling an additional $20,000.00. In 1938, appellant loaned them sums totaling $25,700.00. Generally, these loans were made by the appellant to the bankrupts informally, and upon a mere request, some of which were evidenced only by I.O.U.'s, and handled in a very casual manner. (Appendix, pages 47, 52 to 55.) By December, 1938, the bankrupts owed appellant $95,700.00. On February 24, 1939, additional credits and cash due to appellant by the bankrupts brought the total to $100,000.00. From February 24, 1939 (the date of the security

transaction), to the date of bankruptcy, appellant loaned the bankrupts $8,350.00. (Appendix, page 117.)

The incident leading up to the obtaining of security by the appellant was his desire to leave the employ of the bankrupts because of poor health. (Appendix, pages 7 to 10, 13, 17, 19.) The bankrupts assented to his request for security. (Appendix, pages 10, 11, 13, 30.) The only problem that was left to work out was the type of security that he should be given. (Appendix, pages 83 to 86.) After preliminary discussions as to the type of security, it was agreed that there should be assigned to the appellant pawn tickets of the bankrupts of a value in excess of the amount of his claim. (Appendix, pages 83 to 86.)

At the time of the execution of the security contract of February 24, 1939, the appellant did not know of the existence of any other large obligations of the bankrupts. (Appendix, pages 30, 44, 45.) On February 28, 1939, the appellant learned for the first time that the bankrupts had been sued and their property attached by a creditor. (Appendix, pages 21, 22, 24, 25, 31, 39 and 40.) Prior to that date the bankrupts had never discussed their business affairs with appellant, except to tell him that if they had more cash they could do more business. (Appendix, pages 28, 29.)

Appellant assisted the bankrupts in the removal of the attachment by allowing an exchange of part of his assembled and tabulated pawn tickets for other pawn tickets in order to speed the removal of the sheriff

from the premises. (Appendix, pages 26 to 27.) Subsequently, appellant allowed a similar exchange with regard to another creditor. (Appendix, page 43.)

During this period following the attachment, in March, 1939, on one occasion the bankrupts asked the appellant to hold a check that they had given him for a day or two. (Appendix, pages 31 to 32.)

The appellant knew that the cash of the bankrupts in the ordinary course of their business as money lenders would be converted into merchandise, gems and unredeemed pawns. He knew that the bankrupts could always use more money in their business. (Appendix, pages 47 and 28, 29.) He knew that the bankrupts had large numbers of valuable articles of merchandise and unredeemed pawns at the Provident Loan Association and at the State Loan office, the other pawnbroking establishment of the bankrupts. (Appendix, pages 42, 58 to 60.) He was told by the bankrupts that their amusement enterprises were profitable. (Appendix, pages 71 to 76.)

As late as February 28, 1939, the bankrupts stated in the presence of the appellant that they were solvent, and that their assets far exceeded their liabilities; that they were only hard pressed for ready cash. (Appendix, pages 41, 49 to 51.) At no time within the year prior to bankruptcy did the bankrupts sustain any material loss; nor was there any change in the quantum of their assets. (Appendix, page 78a.)

Such books as the bankrupts had were not accessible to appellant. (Appendix, pages 51, 52.)

The appellant voluntarily left the bankrupts' employ on December 24, 1938. (Appendix, pages 5 to 7.) Immediately after the attachment of February 28, 1939, appellant re-entered the employ of the bankrupts (Appendix, pages 5 to 7) and at that time stated that he felt everyone should work to reduce the expense, and he voluntarily lowered his previous salary of $75.00 per week to $50.00 per week. Due to his impaired health, he was to be allowed to work less arduous hours. (Appendix, pages 16 to 19.)

We urge that under the law these facts fall far short of presenting a case of knowledge of insolvency within the meaning of the Bankruptcy Act. If anything, the record discloses that the Appellant had reasonable cause to believe that the bankrupts were solvent. The applicable rule is summarized in 4 Remington on Bankruptcy, Sec. 1827:

> "Reasonable cause is belief that a preference would be effected but the transaction necessarily involves reasonable cause to believe that the debtor was in fact insolvent, and this means reasonable cause for belief that his assets at fair valuation do not equal his liabilities."

In the case of In re Solof, 2 Fed. (2d) 130 (9 Circ.), in determining whether a creditor had reasonable cause to believe that a preference was intended the court stated at page 131:

> " 'It is not enough that a creditor has some cause to suspect the insolvency of his debtors; but he

must have such a knowledge of facts as to induce a reasonable belief of his debtor's insolvency, in order to invalidate a security taken for a debt. To make mere suspicion a ground of nullity in such a case, would render the business transactions of the community altogether too insecure. . . . A man may have many grounds of suspicion that his debtor is in failing circumstances, and yet have no cause for a well-grounded belief of the fact. He may be unwilling to trust him further; he may feel anxious about his claim, and have a strong desire to secure it—and yet such belief as the act requires may be wanting. Obtaining additional security, or receiving payment of a debt, under such circumstances, is not prohibited by the law.' . . .

Counsel for appellant directs our attention to a large number of, what he terms, 'badges of reasonable cause to believe,' such as information contained in a financial statement; advice to the debtor to make no large payments to creditors; to make payments on a pro rata basis only; refusal to ship further goods; accepting return of merchandise; information that creditors were pressing; protested checks and trade acceptances; requirement that payments be made in cash or cashier's check; extensions requested; failure to inspect books when the opportunity presented itself; and an intimate knowledge of the business affairs of the debtors. All these circumstances may, and doubtless do, indicate that the creditor was apprehensive as to its claim; but they do not necessarily prove that it had a reasonable cause to believe that a preference was intended. Other testimony in the case throws some light on the general situation.

The bankrupts had conducted a large and extensive business for some years prior to bankruptcy. So far as the record discloses, no question as to their financial standing arose until late in the year 1922 or early in 1923. They continued to conduct their business in the usual and ordinary course up to the filing of the involuntary petition against them. During the four months' period, they paid to creditors on open account, notes payable, and trade acceptances, the sum of approximately $168,000, and purchased merchandise on credit, to the amount or value of approximately $111,000.00. Were creditors to whom these vast sums were paid all preferred, and were wholesalers selling merchandise on credit to a concern of known insolvency or even of questionable solvency? These questions suggest their own answer. It may be urged that the appellee had knowledge of facts not possessed by other creditors, but we are not convinced that such was the case."

In Valley National Bank v. Westover, 112 Fed. (2d) 61 (9 Circ.), it appeared that a suit was brought by the trustee in bankruptcy to recover payments made by the bankrupt to the appellant bank on the ground that they were preferential payments. The appellant bank challenges the finding of fact of the trial court that it had reasonable cause to believe that the payments made to it would effect a preference.

Two circumstances were strongly relied upon by the trustee to sustain the finding of the trial court that appellant knew that bankrupt was insolvent when it accepted payment.

The Court, in considering the matter, stated at page 61:

"These two circumstances must be considered in connection with all the other evidence relating to the financial situation of the bankrupt and the dealings of the appellant.

. . . the business of the bankrupt was a relatively small one, recently established, and that its solvency from time to time would depend upon its ability to collect obligations due to it from its customers; . . . as late as June 30, 1937, the bankrupt paid a substantial dividend and paid income taxes upon a profit of about $9000.00. The audit upon which these dividends were paid was brought to the knowledge of, and was considered by the bank at the time two loans, aggregating $2000, were made by it to the bankrupt. . . . It is not claimed that there was any important loss or change in the method of doing business during the period under consideration which would give notice to a casual observer that the company was in any financial difficulty. . . . The first circumstance referred to is the knowledge of the bank of the demand for the payment of $3000 upon an overdue account early in August by the Arizona Sash and Door Company. Its attorney spoke to Carl Gibson, Vice President of the bank, concerning the matter. . . . The loan of August 12, 1937, of $2000 was made by the appellant to the bankrupt while this matter was pending. . . . Half the amount due the creditor was paid August 26, 1937. The balance was allowed to stand. The creditor continued to furnish material to the bankrupt on

credit until the time its property was placed in the hands of a receiver. There is no indication in this circumstance which would reasonably require an inference of insolvency.

The other circumstance relied upon by the appellee was the application for, and refusal of, a loan of $20,000 to the bankrupt on September 20, 1937, by the appellant. As this loan was larger in amount than the stock carried by the bankrupt, the explanation given by the bank . . . is obviously well-founded and involved no conclusion of insolvency.

As to whether or not the payments made by the bankrupt were intended to be preferential and must reasonably have been believed such, it should be said in addition that so far as appears the bank made no effort at any time to collect the amounts it had loaned to the bankrupt. . . . Several of the officers of the bank . . . testified that they had no knowledge of the insolvency of the bankrupt at the time the payments were made by it to the bank . . . there was no intent to make or receive a preferential payment and that the payment was made in the ordinary course of business.

We conclude that there is no evidence to justify the finding of the trial court that the appellant knew or should have known that the payment was preferential. . . . We are satisfied that the judgment must be reversed . . . upon the ground that the trustee has failed to establish knowledge, actual or constructive, of the bank that the payments made to it were intended as a preference." (Italics ours.)

In the case of In re Klein Moffett Co., 28 Fed. (2) 523, D. C. Maryland, in determining whether a creditor had reasonable cause to believe that the bankrupt was insolvent, the Court stated at page 525 of the opinion:

> "But it appears that in the present case the bank had reasonable cause to suppose that the company was not insolvent. It is true that the revised statement showed a very large shrinkage in net worth, but from the statements made to the bank by those presumedly best qualified to know, namely, the company's president and counsel, the bank was justified in believing that the company might be rehabilitated. At least, the bank had a right to take for their face value the statements made to it that, if its temporary embarrassment might be relieved by affording it some ready cash, unfilled orders might be carried out and the business generally revived. Add to this the fact that the company had been a reputable business concern, of considerable size, for many years, a satisfactory, regular client of the bank, and the further fact that the bank elected to forego the exercise of an alternative legal right, which, in contemplation of insolvency, would obviously have been more beneficial to the bank, it is difficult to conclude that the bank, through its officials, is to be charged with having more than ground to *suspect* insolvency.

As we have seen, there is a clear distinction in the law between reasonable belief of a debtor's insolvency and cause to suspect such insolvency. The former creates such a preference; the latter does not. Grant v. First National Bank, supra. It is to

be borne in mind that Section 60a of the Bankruptcy Act does not use the term 'insolvent' in its common law sense, as indicating the inability of a person presently to pay his debts as they mature, but with the meaning as specifically defined in Section 1a (15), namely: 'A person shall be deemed insolvent within the provisions of this title, whenever the aggregate of his property, exclusive of any property which he may have conveyed, transferred, concealed, or removed, or permitted to be concealed or removed, with intent to defraud, hinder, or delay his creditors, shall not, at a fair valuation, be sufficient in amount to pay his debts.' "

11 U. S. C. A., Sec. 1 (15).

In Okin v. Isaac Goldman Co., 79 Fed. (2d) 317 (2 Circ.) at p. 321, the Court states:

"The bankrupt continued in business for nine months after the assignment of the account against the American News Company was made and six months after the assignment of the account against the Public News Company. The defendant had some concern about the bankrupt's indebtedness and its default in the payment of two notes. It required the assignments in order to obtain security if it was to continue to print the magazine. There is no proof that it had any further knowledge of the bankrupt's financial condition, and it continued to advance credit during the period prior to the filing of the petition so that the bankrupt then owed it some $3,000 more than in April, 1931, when the first assignment was made. We think such facts did not give the defendant reasonable

cause to believe that the giving of security would effect a preference even if the bankrupt be thought to have had such an intent."

It is stated in Brookheim v. Greenbaum, 225 Fed. 635-638; Aff'd 225 Fed. 763 (2 Circ.):

> . . . "It does not seem to me that, in the case of a man who concededly did business in such an unbusinesslike way as this bankrupt, shortness of cash and absence of free capital, continuing for so long a period of time without any insolvency, ought to be enough to put on inquiry all those who dealt with him. It must be remembered that something more than suspicion is necessary."

In the case of In re Salmon, 249 Fed. 300 (2 Circ.), it was stated, at page 303:

> " . . . insolvency under the Act means something more than that the debtor was financially embarrassed and hard pressed by his creditors. This condition may exist, and the debtor still be solvent, . . . it would not taken alone be reasonable cause to believe him insolvent, especially in view of the fact that he had made the same remark a year before, and had thereafter told him that he had 'financed' and was 'all right again.' "

In Hurley v. N. J. Reilly, 13 Fed. (2nd) 466 (D. C. Mass.), the Court stated, at page 468:

> "It cannot be said as a matter of law that a creditor, who receives in payment or as security assignments of account, must, as a reasonably

prudent business man, be led to the conclusion that the debtor making the assignments is insolvent, especially if other facts and information known to the creditor justify an honest belief in the solvency of the debtor."

To the same effect, we respectfully direct the Court's attention to the following cases:

Sumner v. Parr, 270 Fed. 675; Aff'd 270 Fed. 677 (2 Circ.);

Marks v. Wenzel, 6 Fed. Supp. 981, Aff'd 70 Fed. (2d) 1019 (2 Circ.);

Everett v. Warfield Mining Co., 37 F. (2nd) 328 (4 Circ.);

Ensley v. First National Bank, 17 Fed. (2) 603; (D. C. Ill.);

Hershon v. Abelson, 69 Fed. (2nd) 102 (2 Circ.) (Cert. den. 292 U. S. 642).

From the evidence, we have seen the following facts among others, are established:

(1) The appellant had no intimate knowledge of the financial condition of the bankrupts.

(2) The appellant did not know of the existence of other large creditors nor that the bankrupts were unable to pay their debts until after his security contract.

(3) The appellant had no knowledge of the books of the bankrupts nor opportunity to examine the same.

(4) The bankrupts were conducting their business in the usual and ordinary course at the time of the execution of the security contract of February 24, 1939, and thereafter.

(5) The bankrupts during the entire period in question and up to bankruptcy did not sustain any important loss or change in assets or liabilities.

(6) The appellant advanced credit to the bankrupts up to the date of bankruptcy.

(7) Shortness of cash did not indicate failing circumstances; it was a token of good business, and in any event had existed from 1936 without insolvency. For over 10 years the bankrupts had regularly borrowed cash from the appellant.

(8) The bankrupts believed, and informed the appellant, that they were solvent, with large amounts of receivables, and other valuable assets, and short only of cash.

It is submitted that there is an utter want of facts upon which to base the finding of knowledge of insolvency, and that applying the law as set forth in the foregoing decisions, to the facts herein, the conclusion must be reached that the appellant did not have reasonable, or any cause, to know or believe that the bankrupts were insolvent at the time of the transfers.

CONCLUSION

We respectfully urge that upon the grounds herein set forth, to wit, that the agreements between the appellant and bankrupts were valid, and that no preference was effectuated within the bankruptcy law, and that the Trustee failed upon the issue of knowledge of insolvency, the decision of the lower court be reversed.

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